

**DEPARTMENT OF STATE REVENUE**  
**LETTER OF FINDINGS: 02-0528**  
**Indiana Individual Income Tax**  
**For the 1999 Tax Year**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUE**

**I. Distributions from S Corporation to Shareholder – Individual Adjusted Gross Income.**

**Authority:** IC 6-3-1-3.5; 45 IAC 3.1-1-1; Harris v. United States, 902 F.2d 439 (5<sup>th</sup> Cir. 1990); Estate of Leavitt v. Commissioner, 875 F.2d 420 (4<sup>th</sup> Cir. 1989); I.R.C. § 1368(b).

Taxpayer disagrees with the audit's conclusion that taxpayer – as sole shareholder – received distributions in excess of the taxpayer's basis in the S Corporation and in excess of the taxpayer's salary. Instead, taxpayer argues that the excess distributions were in fact a shareholder loan and that the excess distributions were not, in fact, taxable income.

**STATEMENT OF FACTS**

Taxpayer works as a healthcare provider. Taxpayer's practice is organized as an "S Corporation." To finance the business, taxpayer signed a promissory note with a bank in 1998.

The Department of Revenue (Department) conducted an audit review of taxpayer and the S Corporation. At that time, the audit review came to a preliminary conclusion that the taxpayer had received distributions from the S Corporation in excess of her stock basis in the corporation and in excess of her salary. In arriving at that conclusion, the audit concluded that although it was taxpayer who signed for the bank loan, "this appeared to be a substance-over-form type issue where the corporation was taking responsibility for the debt used to buy the [corporation's] assets."

The taxpayer disagreed with the audit's preliminary conclusions arguing that the purported excess distributions were misclassified on the S Corporation's 1999 Form 1120S. Taxpayer argued that the purported distributions were – in reality – payments for the bank loan. Taxpayer maintained that the payments were, as a matter of convenience, made to the taxpayer but that the taxpayer turned around and directed the payments to the bank.

The audit concluded that taxpayer's explanation would be acceptable if it could be demonstrated that taxpayer forwarded the amounts to the bank as payments on the original 1998 bank loan. Thereafter, the audit was informed that the amounts were not forwarded to the bank but that amounts – originally classified by the S Corporation as “excess distributions” – were actually loans to the taxpayer. Despite the turnaround in position, the audit determined that this would be a “workable solution.” Taxpayer offered to provide amended returns reflecting that “workable solution.”

However, when the amended returns were submitted, the returns did not include a shareholder (taxpayer) loan receivable on the S Corporation's books. Instead the amended returns included a reduction in the bank note payable by the corporation and an equal reduction in shareholder distributions. In effect, taxpayer argues that the note payable was, in actuality, a note payable to the taxpayer; therefore, a netting of the receivable and payable took place.

The audit rejected taxpayer's characterization of the arrangement between taxpayer, S Corporation, and the originating bank concluding that “[y]ou cannot distribute debt.”

Taxpayer challenged the audit report's conclusion and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative further explained the reasons for the protest. This Letter of Findings follows.

## **DISCUSSION**

### **I. Distributions from S Corporation to Shareholder** – Individual Adjusted Gross.

When taxpayer began her health care practice, she did so in the form of an “S Corporation.” Taxpayer was the sole shareholder of the S Corporation. To fund the startup costs, taxpayer arranged for a bank loan. This amount was invested in the S Corporation and formed the “basis” of the taxpayer's interest in the S Corporation.

The Indiana tax rules piggyback on the federal income tax regulations. IC 6-3-1-3.5 states as follows: “When used in IC 6-3, the term ‘adjusted gross income’ shall mean the following: (a) In the case of all individuals ‘adjusted gross income’ (as defined in Section 62 of the Internal Revenue Code) . . .” *See also* 45 IAC 3.1-1-1.

Therefore, the federal rules are used to determine whether the “distributions” were received as taxable income by taxpayer. Most distributions from an S Corporation are tax free to the shareholder or shareholders. Tax is imposed on the shareholder's “distributive share” of the S Corporation's income. However, any such distributions reduce the basis of the taxpayer's corporate stock. If the distribution amounts ever exceed the amount of “basis” – the amount originally invested – the amount received is treated as a capital gain. I.R.C. § 1368(b).

Originally the payments at issue were classified as distributions on the taxpayer's return and in the taxpayer's general ledger. However, taxpayer filed amended returns reclassifying the amounts and now argues that the payments were – in reality – tax free loan repayments directed toward reducing the amount owed to the bank. Additionally, taxpayer argues that the payments

were distributions of the S Corporation's debt and that these "debt distributions" were also tax exempt.

The Department is unable to agree that an S Corporation can distribute its debt in the form of tax-free payments made to the sole shareholder. In addition, the Department is unable find an indication that any of the payments made to the taxpayer (as sole shareholder) were actually intended as loan payments and that – having received the payments – taxpayer turned around and paid the money to the bank. Instead, there is nothing to refute the audit review's conclusion that the S Corporation "appears to make all loan payments and the loan has been treated as a corporate loan even though the original loan was executed in the [taxpayer's] name individually." What taxpayer appears to be suggesting is that taxpayer increased its basis in the S Corporation by making the loan payments via the taxpayer. However, the courts have held that a "shareholders' guarantees of loans to their Subchapter S corporation could not increase their bases in their stock in the corporation unless the stockholders made an economic outlay by satisfying at least a portion of the guaranteed debt." Harris v. United States, 902 F.2d 439, 442 (5<sup>th</sup> Cir. 1990). Unless the loan guarantee "cost" the shareholder something – i.e. constituted an economic outlay on the part of the shareholder personally – the shareholder's basis in the S Corporation remained unaffected. *See* Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 & n.9 (4<sup>th</sup> Cir. 1989).

Following the filing of the initial returns in which payments were characterized as distributions in excess of basis, taxpayer has recharacterized and re-recharacterized the payments. The Department is unable to conclude that any of the subsequent clarifications and explanations is entirely satisfactory. At the end of the day, taxpayer's original reported explanation of the payments as distributions in excess of basis appears to comport most closely with the arrangement between taxpayer, the S Corporation, and the originating bank.

### **FINDING**

Taxpayer's protest is respectfully denied.